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Skadden

Inside the Courts
An Update From Skadden Securities Litigators

US Supreme Court

Supreme Court Strictly Construes Time Limit for Seeking Permission to Appeal Class Certification Orders

Nutraceutical Corp. v. Lambert, No. 17-1094
(U.S. Feb. 26, 2019)
Click here to view the opinion.

The U.S. Supreme Court held that the 14-day deadline for requesting permission to appeal an order granting or denying class certification is not subject to equitable tolling. Under Federal Rule of Civil Procedure 23(f), parties are generally required to file a petition requesting permission to appeal an order granting or denying class certification within 14 days after the order is entered. After the district court in *Nutraceutical* decertified a class that it had initially certified, the plaintiff failed to file a petition for leave to appeal that decision within the applicable 14-day deadline.

The Ninth Circuit nonetheless determined that the plaintiff's Rule 23(f) petition was timely. It held that Rule 23(f)'s 14-day deadline may be equitably tolled. According to the Ninth Circuit, equitable tolling of the deadline was warranted because the plaintiff had verbally conveyed an intention to move for reconsideration of the district court's decertification order before the deadline expired.

The Supreme Court reversed in a unanimous decision. The Court acknowledged that, because Rule 23(f)'s time limit is found in a procedural rule, not a statute, it is properly classified as a "nonjurisdictional claim-processing rule." According to the Court, however, "[w]hether a rule precludes equitable tolling turns not on its jurisdictional character but rather on whether the text of the rule leaves room for such flexibility." The Court held that the Federal Rules of Appellate Procedure "express a clear intent to compel rigorous enforcement of Rule 23(f)'s deadline, even where good cause for equitable tolling might otherwise exist." In particular, Federal Rule of Appellate Procedure 5(a)(2) states that petitions for leave to appeal "must be filed within the time specified," and Federal Rule of Appellate Procedure 26(b)(1) explicitly precludes extensions of time for petitions for leave to appeal.

The Supreme Court's decision adds clarity and certainty to the process of seeking to immediately appeal orders granting or denying class certification. It is now clear that, unless waived or forfeited, Rule 23(f)'s 14-day deadline is mandatory and inflexible.

Definition of a Security

California District Court Reverses Course, Grants Preliminary Injunction in Crypto Case Alleging Section 17 Violation After Initially Denying Such Injunction

SEC v. Blockvest, LLC, No. 3:18-cv-02287-GPC-MSB
(S.D. Cal. Feb. 14, 2019)
Click here to view the opinion.

Judge Gonzalo P. Curiel granted the Securities and Exchange Commission's (SEC) motion for partial reconsideration of the court's November 2018 order denying a preliminary injunction against Blockvest for violating Section 17(a) of the Securities Act. In its original November 2018 order, the court found that the SEC had failed to make the requisite showing that Blockvest's "BLV" tokens were "securities" under the federal securities laws because there was insufficient evidence that Blockvest's early test investors had invested money in the tokens with an expectation of profits. After the SEC moved for reconsideration, however, Judge Curiel granted the motion for preliminary injunction, holding that the SEC had sufficiently established a *prima facie* case that Blockvest's promotional materials concerning the initial coin offering (ICO) of its BLV tokens constituted an offer of unregistered securities in violation of Section 17(a).

To obtain a preliminary injunction, the SEC first had to establish a *prima facie* case of a violation of federal securities laws. Here, the SEC alleged that Blockvest violated Section 17(a) by offering unregistered securities.

In analyzing whether the SEC sufficiently made the requisite showing for purposes of a preliminary injunction, the court first addressed whether the SEC had made out a *prima facie* case that the BLV tokens constitute "securities" within the meaning of the federal securities laws. Section 2(a)(1) of the Securities Act defines "security" to include, *inter alia*, "any note, stock, treasury stock ... bond ... [or] investment contract." 15 U.S.C. § 77b(a)(1). The district court employed the U.S. Supreme Court's three-part test from *SEC v. W.J. Howey Co*., 328 U.S. 293 (1946), to determine if the BLV tokens could be considered an "investment contract." That three-part test requires (1) an investment of money (2) in a common enterprise (3) with an expectation of profits produced by the efforts of others. The district court emphasized that, "[i]n determining whether a transaction constituted a 'security' based on an offer and/or sale to investors, the Ninth Circuit looks to the specific promotional materials presented to the 'investors.'" The court also recalled the Supreme Court's guidance in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943): "The test [for determining whether an instrument is a security] ... is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."

Here, as to the first *Howey* requirement, the court found that BLV tokens were an investment of money because the evidence presented indicated that the company's website and the white paper the company posted online invited potential investors to exchange currency for BLV. With regard to the second *Howey* requirement, the Blockvest promotional materials that the SEC submitted to the court described BLV as a common enterprise, wherein funds from the tokens would be pooled and distributed according to a profit-sharing formula. As for the third *Howey* requirement, the court determined on the record before it that the profits of BLV were to come solely from the efforts of others because the company's website and white paper sought "passive" investors and claimed that the tokens would generate "passive income." Given the statements in the specific promotional materials that the defendants had presented to investors, the court held that the SEC had met its burden at the preliminary injunction stage to show that BLV tokens were a security, and that Blockvest's website, white paper and social media posts concerning the ICO of the BLV tokens constituted an "offer" of unregistered securities, in violation of Section 17(a).

New Jersey District Court Denies Motion to Dismiss, Finds Plaintiff Adequately Alleged That Cryptocurrency Was a Security

Solis v. Latium Network, Inc., No. 18-10255 (SDW) (SCM) (D.N.J. Dec. 10, 2018)
Click here to view the opinion.

Judge Susan D. Wigenton denied Latium's motion to dismiss a claim brought under Section 12(a)(1) of the Securities Act, holding that the plaintiff plausibly alleged that Latium's cryptocurrency, LATX, was a security and, therefore, plausibly alleged that Latium had offered and sold unregistered securities in violation of the statute.

To bring suit under the federal securities laws, an investor must make the threshold showing that the interest in question is a "security." The defendant did not dispute the first requirement under *Howey*. With regard to the second requirement, the court held that the plaintiff plausibly alleged that Latium was a common enterprise because the company pooled funds from LATX to develop the platform, and investors' return on their investment was proportional to their LATX tokens. As for the third requirement, the plaintiff plausibly alleged that investors expected profits from the efforts of a third party because Latium referred to LATX as a "unique investment opportunity," and investors were dependent on the company to develop the platform.

Fiduciary Duties

Court of Chancery Concludes That *Corwin* Does Not Entitle Directors to Business Judgment Rule Due to Uninformed Vote

In re Tangoe, Inc. Stockholders Litig., C.A. No. 2017-0650-JRS (Del. Ch. Nov. 20, 2018)
Click here to view the opinion.

On November 20, 2018, Vice Chancellor Joseph R. Slights III denied a motion to dismiss filed by directors of Tangoe, Inc. and held that (1) the *Corwin* doctrine did not apply and (2) the plaintiff pleaded a nonexculpated claim for breach of the duty of loyalty.

The action arose from a tender offer by a private equity firm to take Tangoe private. In March 2016, Tangoe announced that the SEC had detected false statements in its financials and that it would have to restate them for several years. Tangoe struggled to complete the restatement, which prompted Nasdaq to delist its stock and the SEC to threaten deregistration. The restatement also impacted the directors' compensation, which largely consisted of equity incentives, because the issuance of equity compensation was barred while the restatement was pending. Accordingly, Tangoe entered into equity award replacement compensation agreements (EARCAs) with each of the directors that would be triggered only upon a change of control and would provide them with the same amount of equity compensation they would have received had their normal awards been available. At that point, the board pivoted from completing the restatement to selling the company. Private equity firm Marlin Equity Partners (Marlin), one of several large stockholders threatening to launch a proxy contest, initiated a tender offer at $6.50 per share (a 28 percent negative premium), and on April 27, 2017, the board approved the proposed transaction, and a majority of Tangoe's stockholders tendered their shares.

The complaint alleged that the directors breached their fiduciary duties by agreeing to sell the company for an inadequate price and for failing to disclose all material information to stockholders. The directors moved to dismiss the complaint, arguing that (1) they were entitled to business judgment rule deference under *Corwin* and (2) the plaintiff failed to plead a nonexculpated claim against them for breach of the duty of loyalty.

First, the court held that *Corwin* did not apply because it was reasonably conceivable that the stockholder vote was uninformed. The court explained that Tangoe's disclosures regarding the proposed transaction omitted material information by (1) failing to provide stockholders with audited financial statements and (2) failing to disclose whether (or when) the restatement would be completed. With respect to the first disclosure deficiency, the court explained that stockholder approval of the transaction was not fully informed in the absence of adequate financial information because stockholders faced an information vacuum, given the sporadic and heavily qualified financial information the board provided to stockholders and the company's failure to file multiple quarterly reports and hold an annual meeting. With respect to the second disclosure deficiency, the court explained that the stockholders' need for information regarding the restatement was critically important when considering whether to tender into the transaction because the restatement stakes were high, given Tangoe's delisting from Nasdaq, threats of deregistration from the SEC and the proxy contest. The court held that information about the restatement process was also material because the delisting depressed the amount potential acquirers were willing to pay for Tangoe, and stockholders needed to understand whether the delisting was likely to continue or whether the company had a legitimate prospect of completing the restatement and regaining its listed status with Nasdaq.

Second, the court held that the plaintiff had pleaded a nonexculpated claim for breach of the duty of loyalty because it was reasonably conceivable that the directors approved the underlying transaction for self-interested reasons. One source of conflict, the court explained, was the EARCAs, which incentivized the directors to steer Tangoe into a sale of the company, because a sale was the most likely means by which the directors would receive the equity awards they would have received if the company had completed the restatement. The court emphasized that the timing of the agreements further supported the plaintiff's theory of director self-interest because it allowed for a reasonable inference that a temporal connection existed between the adoption of the EARCAs and the decision to shift course toward a sale of Tangoe. The court also identified the looming threat of a proxy contest, evidenced by letters the board had received from large stockholders (including Marlin) threatening to replace them, as a second source of director conflict, because the threat of a proxy contest was coupled with other pleaded facts, including the board's struggles to complete the restatement, its adoption of the EARCAs and its recommendation to stockholders to accept steadily decreasing offers from Marlin to acquire the company.

Forum Selection Provisions – Corporate Charters

Court of Chancery Finds Federal Securities Law-Related Forum Selection Provision Invalid as Matter of Delaware Law

Sciabacucchi v. Salzberg, C.A. No. 2017-0931-JTL
(Del. Ch. Dec. 19, 2018)
Click here to view the opinion.

Vice Chancellor J. Travis Laster invalidated a forum selection provision contained in a Delaware corporation's charter designed to regulate the forum where claims related to the corporation could be brought under the Securities Act. He reasoned that "[a] 1933 Act claim is an external claim that falls outside the scope of the corporate contract."

The three nominal defendants in the action each had filed a registration statement in connection with their respective initial public offerings (IPOs). Before filing the statement, each company had adopted similar "charter-based" federal forum provision that required any claim under the Securities Act to be filed in federal court. One of the companies, Blue Apron, adopted a federal forum provision with a "savings clause." The nominal defendants adopted these provisions to prevent securities holders from bringing Securities Act claims in state court. After the federal forum provisions were adopted, the plaintiff bought shares of each corporation and then filed suit in the Court of Chancery, seeking a "declaratory judgment that the Federal Forum Provisions are invalid." On cross-motions for summary judgment, the court found the provisions invalid.

In invalidating the provision, the court relied on related precedent in this area of law that "stressed that Section 109(b) [of the DGCL] does *not* authorize a Delaware corporation to regulate external relationships." Such prior decisions had "noted that a bylaw cannot dictate the forum for tort or contract claims against the company, even if the plaintiff happens to be a stockholder." The court drew an analogy to that reasoning, holding that the "distinction between internal and external claims answers whether a forum-selection provision can govern claims under the 1933 Act. It cannot, because a 1933 Act claim is external to the corporation." In reaching this conclusion, the court reasoned that "[b]ecause the state of incorporation creates the corporation, the state has the power through its corporation law to regulate the corporation's internal affairs. ... But the state of incorporation cannot use corporate law to regulate the corporation's external relationships." The court explained, among other things, that "[a] claim under the 1933 Act does not turn on the rights, powers, or preferences of the shares, language in the corporation's charter or bylaws, a provision in the DGCL, or the equitable relationships that flow from the internal structure of the corporation. ... [A] 1933 Act claim is distinct from 'internal affairs claims brought by stockholders *qua* stockholders.'"

Finally, the court rejected a ripeness and savings clause argument, finding that "facial challenges" to the legality of charter provisions are regularly decided by the court, and the savings clause defense failed "because there is no context in which Blue Apron's Federal Forum Provision could operate validly."

Insider Trading

Second Circuit Affirms Conviction of Law Firm Partner for Insider Trading

United States v. Klein, No. 17-3355 (2d Cir. Jan. 10, 2019)
Click here to view the opinion.

The Second Circuit affirmed the district court's judgment convicting a former law firm partner of conspiracy to commit securities fraud in violation of 15 U.S.C. § 371 and of securities fraud in violation of Section 10(b) of the Securities Exchange Act. A jury had found that the former law firm partner had engaged in a conspiracy to trade in the securities of his client — a pharmaceutical company — using material, nonpublic information about a potential merger he obtained through his representation, by telling his financial advisor and friend that "it would be nice to be [the pharmaceutical company] for a day."

Although the former partner argued that the government presented no evidence that he intended for his financial advisor to trade on the comment he made, the Second Circuit held that the jury was entitled to disbelieve that he only made that statement. The Second Circuit reasoned that "[A]s a matter of common sense," the former partner had to have communicated additional information to his financial advisor, who immediately thereafter traded the pharmaceutical company's stock. The Second Circuit further noted that the trial record was "replete with evidence" supporting an inference that the former partner intended for his financial advisor to trade on the information. The financial advisor had discretionary authority to trade in his account and in fact bought hundreds of thousands of dollars of the pharmaceutical company's stock after receiving the tip, including for the former partner's benefit. Additionally, the financial advisor had previously purchased stock in one of the former partner's clients.

The Second Circuit reasoned that there is no requirement that the government provide evidence of multiple conversations between co-conspirators or that the government provide direct testimonial evidence regarding a defendant's intent. The Second Circuit also held that the evidence supporting the inference that the former partner intended for his financial advisor to trade on the insider information was not on balance with evidence supporting an inference that he intended merely to boast about the company

Interpreting *Omnicare*

District of Massachusetts Dismisses Claims That Women's Apparel Company Misled Investors in Connection With IPO

The Pension Trust v. J.Jill, Inc., Civil Action No. 1:17-cv-11980-LTS (D. Mass. Dec. 20, 2018)
Click here to view the opinion.

Judge Leo. T. Sorokin dismissed claims brought by a putative class of investors against a women's apparel company alleging that the company violated Sections 11 and 12(a)(2) of the Securities Act by including false and misleading statements in its offering documents filed in advance of its March 2017 IPO and during a subsequent earnings call. The complaint alleged that the company, which touts an "omni-channel" marketing platform, including online and brick-and-mortar retail stores, failed to disclose that it was susceptible to certain retail trends and considerations that affect the retail industry as a whole. The complaint further alleged that the company failed to disclose that it needed to increase promotional efforts to sell slow-moving inventory, that a number of the company's brick-and-mortar stores were failing and would shutter, and that the company's ability to service its debt had been materially impaired. The complaint alleged that these omissions violated Items 303 and 503 of SEC Regulation S-K. The complaint further alleged that the company's executives misled investors during a May 2017 earnings call by conveying expectations for reduced growth margin rates in upcoming quarters without fully disclosing the underlying reasons, which did not come to light until an October 2017 press release where the company lowered its expectations for the fiscal quarter.

Judge Sorokin held that the complaint failed to adequately allege a misstatement or omission. He first determined that the statements made in the May 2017 earnings call were in actionable opinions under the U.S. Supreme Court's decision in *Omnicare v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1327 (2015). Judge Sorokin also determined that "[a]t most, the call suggests what the executives said expressly, that in light of then-current adverse general economic conditions, they were providing cautious guidance for the remainder of the year." Judge Sorokin rejected the argument that the opinion statements were nonetheless actionable because they were made without sufficient inquiry, finding that the complaint had "identified no particular and material facts relating to the inquiry [the company] purportedly did not conduct." Judge Sorokin also found that the statements made in the IPO offering documents about the company's future prospects were improperly pleaded as "fraud by hindsight." Finally, he determined that the "risk factor" disclosures contained the very risks that the complaint alleged the company had failed to disclose.

Mutual Fund Litigation

District of New Jersey Dismisses Excessive Advisory Fee Case After Eight-Day Bench Trial

In re BlackRock Mut. Funds Adv. Fee Litig., No. 3:14-cv-01165-FLW-TJB (D.N.J. Feb. 8, 2019)
Click here to view the opinion.

Judge Freda L. Wolfson of the District of New Jersey ruled in favor of certain subsidiaries of BlackRock, Inc. on $1.55 billion in claims brought under Section 36(b) of the Investment Company Act concerning two of BlackRock's largest mutual funds. The case is one of the largest cases ever filed involving the mutual fund industry.

Section 36(b) imposes a fiduciary duty on investment advisers with respect to the receipt of compensation they receive for providing services to mutual funds. Under Section 36(b) and relevant precedent, an adviser may not charge the funds it manages a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not be the product of arm's length bargaining. Against that backdrop, the plaintiffs — investors in the funds at issue — brought suit claiming that BlackRock breached its fiduciary duty under Section 36(b) by charging excessive fees to the funds. According to the plaintiffs, BlackRock's advisory fees during the relevant period were excessive because it charged lower fees to provide allegedly substantially the same services as a subadviser to variable annuity mutual funds managed by third-party advisers.

After hearing evidence, the court found that the plaintiffs' comparison of an investment adviser's advisory and subadvisory services was inapt. In particular, the court found that BlackRock's limited subadvisory services were not "remotely comparable" to the "robust" suite of advisory services it provides to the funds at issue. In particular, the court found that advisory and subadvisory services are substantially different, including (but not limited to) with respect to: "(i) compliance; (ii) board administration; (iii) regulatory and financial reporting; (iv) determination and publication of daily NAV; and (v) managing service providers," such as accountants, transfer agents and custodians. In so holding, the court also acknowledged the value of BlackRock's coordination and oversight of the funds' third-party service providers, which it found to require "substantial effort," and the unique risks borne by BlackRock as adviser that it did not bear in its capacity as subadviser.

Ponzi Schemes

Tenth Circuit Affirms Lower Court Ruling on Purported Internet Advertising Services Company, Concluding That Its Products Are Securities

SEC v. Scoville, No. 17-4059 (10th Cir. Jan. 24, 2019)
Click here to view the opinion.

A panel of the Tenth Circuit affirmed a preliminary injunction prohibiting a purported internet advertising services company from operating its business, and also affirmed a related district court order appointing a receiver over the company's business and assets. While the SEC argued that the company was operating a Ponzi scheme, the company asserted that it was a "legitimate internet traffic exchange offering internet advertising services" to its members, 90 percent of whom were located outside the United States. One of its products was AdPack, which entitled a member to receive a certain number of visits to the member's website and share in the company's revenues, provided that the member clicked on other members' advertisements a requisite number of times. Members could also earn money by recruiting other members. The SEC contended that these practices violated Sections 17(a)(1) and (a)(3) of the Securities Act and Section 10(b) of the Securities Exchange Act. After an evidentiary hearing, the district court granted the SEC's request for a preliminary injunction.

On appeal, the Tenth Circuit first concluded that the anti-fraud provisions of the federal securities laws applied to sales of AdPacks overseas. As the Dodd-Frank amendments made clear, federal courts have jurisdiction over proceedings involving conduct taken within the United States that constitutes a significant step in furtherance of a violation of the securities laws. The court found that this test was satisfied because the company was created in the United States, AdPacks were promoted by the company's founder who resided in the U.S. and the company's computer servers were located in the U.S.

The Tenth Circuit further concluded that AdPacks were "securities" within the meaning of federal securities laws, since they qualified as "investment contracts" under the three-part test set forth in *Howey*. AdPacks offered their purchasers an opportunity to share in the company's revenue and AdPack purchases were investments in common enterprises. AdPacks also provided members with "a reasonable expectation of profit derived from the entrepreneurial or management efforts of others," as members expected the company's success to depend on its efforts to sell its advertising services.

Eighth Circuit Affirms Grant of Summary Judgment for Defendant Bank on Claim of Aiding and Abetting a Ponzi Scheme

Zayed v. Associated Bank, N.A., No. 17-1250 (8th Cir. Jan. 10, 2019)
Click here to view the opinion.

The Eighth Circuit affirmed the grant of summary judgment by the District of Minnesota to the defendant bank on claims of aiding and abetting a Ponzi scheme. A receiver appointed to control the remaining assets in the business entities used to perpetrate the scheme brought the case in an effort to recover assets for victims of the fraud. The receiver sued Associated Bank, which provided banking services to some of the scammers' businesses, alleging the bank aided and abetted the fraudsters in committing the torts of conversion, breach of fiduciary duty, fraud and negligent misrepresentation under Minnesota law. The receiver alleged that a former bank employee, who helped the scammers open accounts and serviced those accounts, had knowledge of and assisted in the Ponzi scheme. The district court granted the defendant bank's motion for summary judgment, concluding there was insufficient evidence that the bank knew of and provided substantial assistance to the scammers' tortious conduct.

In analyzing the evidence in the summary judgment record, the Eighth Circuit similarly found no direct evidence that Associated Bank had knowledge of the Ponzi scheme. The receiver's own expert witness stated that no one at the bank concluded the scammers' entities were engaged in a Ponzi scheme, two of the scammers testified that the bank employee did not know about the scheme and the circumstantial evidence did not collectively allow for a conclusion of knowledge without resorting to speculation. The court rejected the receiver's alternative argument that constructive knowledge is sufficient under Minnesota law and found it unsupported by the record even if it were.

The court further held that no reasonable fact-finder could conclude the bank provided substantial assistance in the commission of torts. Under Minnesota law, substantial assistance requires more that providing routine professional services. The court found no evidence in the record of anything beyond "routine banking services or, at worst, sloppy banking." Accordingly, the Eighth Circuit affirmed the district court's grant of summary judgment to the defendant.

PSLRA – Safe Harbor Provision

Pennsylvania District Court Denies Motion to Dismiss, Finding Plausible Allegations About Drug Abuse

SEB Inv. Mgmt. AB v. Endo Int'l, PLC, CIVIL ACTION NO. 17-3711 (E.D. Pa. Dec. 10, 2018)
Click here to view the opinion.

Judge Timothy J. Savage denied the defendants' motion to dismiss claims brought under Section 10(b) of the Securities Exchange Act, holding that the alleged misrepresentations were not subject to the PSLRA's safe harbor provision.

The plaintiffs alleged that Endo misrepresented and omitted facts about the safety and efficacy of Opana ER, an opioid pain medication. From 2011 to 2017, Endo sought approval from the Food and Drug Administration (FDA) to label the drug as "abuse-deterrent." During this time, certain Endo officers made claims that data regarding the safety of the drug was "robust," "very encouraging" and reflected an 80 percent reduction in abuse compared to a previous version of the drug. In June 2017, the FDA asked Endo to withdraw the drug from the market because of data showing that the drug was highly susceptible to abuse. The plaintiffs allege that while Endo was seeking FDA approval, the company knew about data showing that the drug was susceptible to abuse and knew the impact that data would have on the FDA's approval. The defendants argued that the allegedly misleading statements were protected by the PSLRA's safe harbor provision.

The court found that while some of the alleged misstatements were protected under the safe harbor provision, others were not. The court explained that although the PSLRA's safe harbor protects forward-looking statements that include cautionary language, even facially forward-looking statements are not protected when "considered in context" with known, contradictory data on the drug's safety and efficacy. The court found that statements that the data was "robust," "very encouraging" and showed lower abuse rates touted the safety of Opana ER while ignoring contrary data. Thus, these statements did not fall under the safe harbor provision.

Inside the Courts
An Update From Skadden Securities Litigators

Section 220 – Books and Records

Delaware Supreme Court Provides Guidance on Availability of Electronic Documents Through Section 220 Demand

KT4 Partners LLC v. Palantir Techs. Inc., No. 281, 2018
(Del. Jan. 29, 2019)
Click here to view the opinion.

On January 29, 2019, the Delaware Supreme Court reversed a decision of the Court of Chancery on two issues raised in an appeal of a stockholder Section 220 Delaware General Corporation Law (DGCL) action for books and records. The stockholder, KT4 Partners LLC, prevailed below on its demand for several categories of the books and records of Palantir Technologies Inc. but argued that the Court of Chancery had erred in not requiring the production of electronic communications and in denying its proposed exception to a jurisdictional use restriction.

On the first issue, the Delaware Supreme Court held that a production order limited to formal board minutes and board materials was insufficient because Palantir did not keep formal minutes. The Supreme Court stated that "[i]f the only documentary evidence of the board's and the company's involvement in the amendments comes in the form of emails, then those emails must be produced." Because KT4 presented sufficient evidence that Palantir did not honor traditional corporate formalities and acted through email in connection with the alleged wrongdoing that KT4 was seeking to investigate, the Supreme Court concluded that KT4 had made a sufficient showing that emails were necessary to investigate potential wrongdoing related to amendments to an LLC agreement. The Supreme Court noted, however, that "[i]f a corporation has traditional, non-electronic documents sufficient to satisfy the petitioner's needs, the corporation should not have to produce electronic documents." The Supreme Court continued, "if a company observes traditional formalities, such as documenting its actions through board minutes, resolutions, and official letters, it will likely be able to satisfy a § 220 petitioner's needs solely by producing those books and records."

As to the second issue, the Supreme Court held that the Court of Chancery abused its discretion by refusing KT4's request to limit a jurisdictional use restriction the Court of Chancery had imposed. In its final order below, the Court of Chancery had imposed a broad restriction on the use of the materials KT4 was entitled to inspect, such that KT4 could not use them in litigation outside the Court of Chancery. The Court of Chancery rejected KT4's requests that it be allowed to bring suit either (1) in the first instance in the Superior Court of Delaware, where other litigation between the parties was pending; or (2) in a court located in another jurisdiction for any nonderivative action where one of Palantir's directors, officers or agents is named as a defendant and that person would not consent to personal jurisdiction in Delaware. The Supreme Court held that because the Court of Chancery found a credible basis to investigate potential wrongdoing related to the violation of contracts executed in California, governed by California law and among parties living or based in California, the Court of Chancery lacked reasonable grounds for limiting KT4's use in litigation of the inspection materials to Delaware and specifically the Court of Chancery.

Court of Chancery Orders Production of Fiduciaries' Emails and Text Messages in Books and Records Action

Schnatter v. Papa John's Int'l, Inc., C.A. No. 2018-0542-AGB
(Del. Ch. Jan. 15, 2019)
Click here to view the opinion.

Chancellor Andre G. Bouchard ordered the production of emails and personal text messages of the directors and certain officers of Papa John's International, Inc. in an action brought pursuant to Delaware's corporate books and records statute, and declined to adopt a bright-line rule that "emails and text messages from personal accounts and devices" are not subject to production in a statutory books and records action.

The case arose from a demand for books and records pursuant to Section 220 of the DGCL by John Schnatter, the company's founder, former CEO and chairman, and current board member, related to the company's decision to sever certain relationships with him in the aftermath of Schnatter's 2017 controversial comments on the NFL and race in America. Schnatter brought the books and record demand both as a stockholder and as a director. Schnatter's stated purpose was to investigate whether members of the company's board breached their fiduciary duties to the company's stockholders with regard to the termination of Papa John's various agreements and relations with Schnatter. Schnatter had already initiated a separate fiduciary duty action against the board while his books and records proceeding was pending.

The court rejected the defendant's argument regarding Schnatter's prior pending fiduciary action and distinguished past decisions that suggested that action rendered his Section 220 request improper. In doing so, the court noted that the Section 220 action was also brought in Schnatter's capacity as a director and that directors with a proper purpose are entitled to "virtually unfettered" access to a company's books and records. With respect to the scope of production and the text messages and emails sought, the court eschewed a "bright-line rule." Relying on prior decisions, it concluded that communications "that affect the corporation's rights, duties, and obligations" can constitute the "books and records of a corporation for purposes of Section 220."

Applying these principles, the court held that custodians who used personal devices to communicate about issues central to the Section 220 request, the termination of relationships with the founder and former CEO and whether such action was consistent with the custodians' fiduciary duties, "should expect to provide that information to the Company." Specifically, the court explained that if the identified custodians "used personal accounts and devices to communicate about changing the Company's relationship with Schnatter, they should expect to provide that information to the Company" and noted that this is not limited to just to emails but includes text messages, which "in the court's experience often provide probative information." While ordering production under these circumstances, the court acknowledged that it "has both granted and denied access to personal email accounts and devices of directors and officers in Section 220 actions."

Securities Exchange Act

Northern District of Texas Court Follows Third and Ninth Circuits' Loss Causation Standard in Securities Fraud Actions Involving Privately Traded Securities

O'Connor v. Cory, CIVIL ACTION NO. 3:16-CV-1731-B
(N.D. Tex. Jan. 3, 2019)
Click here to view the opinion.

The court held that in cases involving privately traded securities — as in cases involving publicly traded securities on an efficient market — establishing loss causation for securities fraud claims requires plaintiffs to show that the alleged misrepresentation caused the claimed economic loss.

Plaintiffs Tammy O'Connor and Michael Stewart entered into an agreement to sell their interest in a company to Atherio, Inc. The plaintiffs later learned that Atherio's chief financial officer, Thomas Farb, would be leaving his position. The plaintiffs sued Farb as well as other Atherio executives, alleging that the purchase agreement contained misrepresentations because the defendants failed to disclose that Farb was stepping down as CFO.

The plaintiffs asserted claims for securities fraud under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, as well as a claim for common law fraud.

The defendants moved for summary judgment, arguing, among other things, that there were no misrepresentations, and that the plaintiffs failed to establish loss causation because they had adduced no evidence that the alleged fraud caused their economic loss. The court found the plaintiffs cited sufficient evidence to create a triable issue as to whether the defendants made misrepresentations.

Turning to loss causation, the court noted that the largest swath of cases from the U.S. Supreme Court and Fifth Circuit addressing this requirement involve publicly traded securities on an efficient market, where a fraud-on-the-market theory (which focuses on the effect a price-inflating misrepresentation and subsequent disclosure has on a security's price in the marketplace) can be applied. The court remarked, however, that neither the Supreme Court nor the Fifth Circuit has addressed loss causation involving privately traded securities where there is no marketplace for the disclosure of negative truthful information to cause a price decline.

Noting the lack of binding precedent on what is needed to prove loss causation in securities fraud cases not involving the purchase of publicly traded securities in an efficient market, the court looked to the Third and Ninth circuits, which have addressed loss causation in this context. The court remarked that in *McCabe v. Ernst & Young, LLP*, 494 F.3d 418 (3d Cir. 2007), the Third Circuit held that although typical fraud-on-the-market cases were inapplicable to private securities sales (because the plaintiff acts based on a personalized misrepresentation that does not implicate larger market forces), the general standard for pleading loss causation is the same regardless of whether the securities were publicly or privately traded. In each case, the plaintiff must demonstrate that the defendant misrepresented or omitted the very facts that were a substantial factor in causing the plaintiff's economic loss. In *Nuveen Mun. High Income Opportunity Fund v. City of Alameda*, 730 F.3d 1111 (9th Cir. 2013), the Ninth Circuit likewise held that the same loss causation analysis applied to both typical Section 10(b) cases (involving publicly traded securities) and nontypical cases (involving the sale of privately traded securities). In both, a plaintiff must "reliably distinguish among the tangle of factors affecting a security's price," regardless of the market.

Following these principles, the court stated that the proper showing for loss causation, even outside the fraud-on-the-market context, is whether the very facts the defendant misrepresented or omitted were a substantial factor in causing the plaintiff's economic loss. Therefore, the court held that to establish loss causation in this case, it was not sufficient for the plaintiffs to show they were "duped or induced into a transaction"; the plaintiffs must show that the misrepresentation regarding Farb's position as CFO was at least a substantial factor in bringing about their economic loss — *i.e.*, the devaluation of the company. Having concluded the plaintiffs failed to meet that standard, the court granted the defendants' summary judgment motion.

Securities Fraud Pleading Standards

Third Circuit Dismisses Fraud Class Action for Failing to Allege Material Misrepresentation

City of Cambridge Ret. Sys. v. Altisource Asset Mgmt. Corp., No. 17-2471 (3d Cir. Nov. 14, 2018)
Click here to view the opinion.

The Third Circuit affirmed the district court's dismissal of the plaintiffs' claim brought under Section 10(b) of the Securities Exchange Act, finding the plaintiffs failed to adequately allege a false or misleading statement.

The plaintiffs, former shareholders, alleged two categories of misrepresentations. First, they alleged that defendant Altisource misled investors by representing its affiliate relationship with mortgage company Ocwen as a "competitive advantage" and an opportunity to "maximize the value of its loan portfolios" when in reality, according to the plaintiff, Ocwen's services were outdated and the company was subject to regulatory violations in the wake of the housing crisis. Second, the plaintiffs alleged that the defendant made misrepresentations regarding its recusal policy.

The court found that the plaintiffs did not plausibly allege that either category of statements was materially misleading. With regard to the statements concerning the defendant's relationship with Ocwen, the court concluded that the plaintiffs failed to plausibly allege that those statements were false because Ocwen met its servicing obligations and there was no reason to think it would not continue to do so. With regard to the recusal policy, the court concluded that the plaintiffs' failure to identify a single transaction in which a purportedly conflicted company officer improperly participated rendered the allegations too speculative to meet the PSLRA's strict requirements. In dismissing the suit, the court opined that, "[w]hen a stock experiences the rapid rise and fall that occurred here, it will not usually prove difficult to mine from the economic wreckage a few discrepancies in the now-deflated company's records. Hindsight, however, is not a cause of action."

Georgia District Court Denies Motion to Dismiss in Equifax Data Breach Case

In re Equifax Inc. Sec. Litig., CIVIL ACTION FILE NO. 17-CV-3463-TWT (N.D. Ga. Jan. 28, 2019)
Click here to view the opinion.

Judge Thomas W. Thrash, Jr. denied Equifax's motion to dismiss a putative federal securities class action alleging misrepresentations regarding the company's data security, holding that the complaint adequately alleged that certain company statements were false or misleading.

The plaintiffs alleged that, prior to a 2017 data breach, Equifax misled investors about its data security, the personal information in Equifax's custody, the vulnerability of its systems, and Equifax's compliance with laws and best practices. Specifically, the plaintiffs claimed it was misleading for Equifax to describe itself as a "trusted steward" of personal data and to tout its "advanced security protections," "highly sophisticated data information network" and "rigorous enterprise risk management program targeting ... data security." In seeking to dismiss the claims, Equifax argued that the plaintiffs did not plausibly allege that the statements were false because the mere existence of a breach did not establish that Equifax's data security was inadequate. Equifax further argued that the alleged misrepresentations were "corporate optimism" and "puffery" that are not actionable under the federal securities laws.

The court agreed with Equifax that the existence of a breach alone "may not necessarily" prove that a company's data security is inadequate. However, the court held that the plaintiffs alleged a "variety of facts" showing that Equifax's security was outdated, below industry standards, vulnerable to attack and a low priority. Additionally, the court found that the statements were not puffery because shareholders could have relied on the statements, given that data security is a core aspect of Equifax's business.

California District Court Dismisses Securities Claim Arising Out of PayPal Data Breach

Sgarlata v. PayPal Holdings, Inc., Case No. 17-cv-06956-EMC (N.D. Cal Dec. 13, 2018)
Click here to view the opinion.

Judge Edward M. Chen granted defendant PayPal's motion to dismiss the plaintiffs' claims brought under Section 10(b) of the Securities Exchange Act alleging a failure to disclose a data breach, finding that the plaintiffs failed to plausibly allege scienter and loss causation.

In November 2017, PayPal announced the discovery of "security vulnerabilities" within a PayPal subsidiary. In December 2017, PayPal announced that the subsidiary had experienced a data breach that compromised the personal information of 1.6 million customers. The stock price dropped in response to that disclosure. The plaintiffs alleged that PayPal knew about the breach at the time of its November 2017 announcement and that, therefore, its statement that there were only "security vulnerabilities" was materially misleading because it gave the impression that there was not already a data breach.

In assessing the plaintiffs' allegations, the court analyzed scienter and loss causation together. The court noted that the plaintiffs argued that the stock price drop in December 2017 was caused not only by the revelation of the data breach but also by disclosure that the breach was so far-reaching as to affect 1.6 million customers. Given that theory, the plaintiffs had to plausibly plead that, at the time of the November 2017 announcement, the defendants knew both that there had been a breach and that the privacy of 1.6 million customers had potentially been compromised as a result. The plaintiffs primarily relied on three former employees' statements to allege such knowledge. In finding those allegations insufficient, the court reasoned that, at most, the former employees' statements established that some PayPal employees "may have known" about the breach. However, the statements did not show that the defendants knew the magnitude of the breach, *i.e.*, that it affected the personal information of 1.6 million customers.

SLUSA Covered Class Action

Seventh Circuit Affirms Dismissal of Suit Barred by SLUSA as Covered Class Action

Nielen-Thomas v. Concorde Inv. Servs., LLC, No. 18-2875 (7th Cir. Jan. 24, 2019)
Click here to view the opinion.

The Seventh Circuit affirmed dismissal of a suit that was precluded by the Securities Litigation Uniform Standards Act (SLUSA) as a "covered class action." Plaintiff Nielen-Thomas originally filed a class action complaint in Wisconsin state court, alleging she and others similarly situated were defrauded by their investment adviser. The putative class consisted of at least 35, but not more than 49, members and the complaint contained nine state law claims. The defendants removed the case to the Western District of Wisconsin and moved for dismissal, arguing that the action was precluded by SLUSA as a "covered class action." The plaintiff contended that her lawsuit did not fall under that definition because her proposed class had fewer than 50 members. The district court dismissed the case with prejudice, holding that the case was a "covered class action" under SLUSA because the plaintiff brought it on behalf of unnamed parties in a representative capacity.

The Seventh Circuit agreed. It noted that Congress passed SLUSA as a response to litigant attempts to file state law class actions in an effort to circumvent barriers to federal securities class actions embodied in the Private Securities Litigation Reform Act. Under SLUSA, a single lawsuit qualifies as a "covered class action" when damages are sought on behalf of more than 50 prospective class members or when a named party seeks to recover damages on a representative basis, and questions of law or fact common to other members of the prospective class predominate. The Seventh Circuit held that SLUSA "unambiguously" precludes the plaintiff's lawsuit, as she sought to bring state law claims on a representative basis and alleged that common questions of law or fact predominate. Accordingly, it affirmed the district court's dismissal with prejudice.

Standing

Western District of Oklahoma Dismisses Putative Class Claims Brought by Investors in Oil and Gas Trust

Duane & Virginia Lanier Trust v. Sandridge Mississippian Trust I,
Case No. CIV-15-634-G (W.D. Okla. Jan. 18, 2019)
Click here to view the opinion.

Judge Charles B. Goodwin dismissed putative class claims against an oil and gas trust (Trust I) brought under Section 10(b) and 20(a) of the Securities Exchange Act. In 2011, an energy company monetized its existing oil and gas assets and created two trusts: Trust I (Oklahoma assets) and Trust II (Oklahoma and Kansas assets). Investors purchased units in both trusts, but the lead plaintiffs-investors had purchased units in only Trust II. The lead plaintiffs alleged that Trust I made material misstatements in its registration statement about its oil projections in Oklahoma. The lead plaintiffs alleged that the misstatements about Trust I caused them to purchase units in Trust II because the oil for both trusts came from the same locations. The plaintiffs also alleged that the two trusts shared the same management.

Judge Goodwin dismissed the lead plaintiffs' claims for lack of standing against Trust I. He reasoned that Section 10(b) only allows purchasers of a security to bring a private civil suit and determined that the amended complaint established that trust units were "independent securities sold by two different entities and publicly traded under two district ticker symbols." Judge Goodwin also held that the two trust units were not contractually linked to each other, and "neither is a derivative instrument whose value is tied to that of the other."

Inside the Courts
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